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Section 274(n), Exception to 20% Disallowance Rule

This is in response to TCR 17-892, originated by Revenue Agent Jeff Jacobson, relating to the above-mentioned subject. The report points out that the application of one of the exceptions to the 20% disallowance rule for meal and entertainment expense deductions can lead to different results from a revenue standpoint depending on the nature of the party that reimburses a taxpayer.

Section 274(n)(1) provides that the amount allowable as a deduction for food, beverages, and entertainment shall not exceed 80% of the amount of the expense for such items. Section 274(n)(2)(A) provides, in part, that this disallowance rule shall not apply to expenses paid by a taxpayer in connection with the performance by him of services for another person under a reimbursement or other expense allowance arrangement with the person.

The legislative history to this exception to the disallowance rule shows that this exception can cause the disallowance rule to apply at the level of the reimbursing party. See S. Rep. No. 313, 99th Cong., 2d Sess. 71, 1986-3 C.B. Vol. 3, and H. Rep. No. 426, 99th Cong., 1st Sess. 124, 1986-3 C.B. Vol. 2. As Agent Jacobson points out, Notice 87-23, 1987-1 C.B. 467, provides an example of the operation of the disallowance rule applying at the level of the reimbursing party in the case of a law firm that has its meal and entertainment expenses reimbursed by a client.

When, however, the reimbursing party is an entity exempt from federal income tax, the reimbursed party will not have its meal and entertainment expense deduction limited as explained above, while the reimbursing party, obviously due to its exempt status, is unaffected by deduction limitations. We acknowledge the disparate revenue consequences of this provision. It seems especially unfair when an independent contractor, if it structures its compensation properly, can get an advantage of this kind. At the same time, if the exception to the disallowance rule were unavailable to taxpayers reimbursed by

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by tax-exempt entities, employees of tax-exempts and governmental units would be at a disadvantage compared to employees of taxable organizations.

Agent Jacobson also points out a problem in cases where a reimbursement arrangement is based on a per diem that does not provide for a separately stated amount for meal and entertainment expenses. For these cases the Service has not provided a method for the reimbursing party to properly apply the 20% disallowance. This question is already being considered by our office as part of a project to produce guidance on section 274(n). We appreciate seeing specific situations such as this to show the dimensions of the problem.

We hope this information adequately responds to your report.

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By

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